

## How a permanent crisis fund can promote European solidarity

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Douglas Voigt

## How a Permanent Crisis Fund can Promote European Solidarity

*The development of a permanent Euro crisis fund will have lasting impacts on the relationships between member states of the European Union. It is therefore essential that the character of this institution reflects not only the relations between member states at the current juncture, but also strengthens member state cooperation in the future.*

With Ireland set to receive an 85 billion Euro loan from the European Union (EU), and Portugal almost certain to follow, the ongoing economic crisis continues to challenge several important aspects of European integration and stability – especially the Euro. Stemming from this active role of the EU in granting emergency loans, the EU has become an important actor in national-level fiscal and monetary decision-making. Furthermore, emerging from potential sovereign debt crises within the Eurozone, the European Council agreed to set up a permanent crisis fund. These developments elucidate the rapid evolution of the Stability and Growth Pact (SGP) and the European Exchange Rate Mechanism II (ERM II), further validating the increasing importance of the EU in national-level fiscal policy both within and outside the Eurozone. However, whether or not a member state engulfed in crisis is in the Eurozone has significant impacts on the relationship between austerity and emergency funding. This is evident by a comparison of the cases of Hungary, Latvia and Greece. The permanent crisis fund offers an opportunity to correct these divergent responses and provide a uniform framework for crisis in the future.

### Entering and Maintaining the Euro

The current purpose of the ERM II is to provide an intermediate step in member-states' transition to the euro. The ERM II is part of the Maastricht Treaty's convergence criteria, which mirror the SGP criteria. Every member state, excepting the United Kingdom, Denmark and in practice Sweden, are obliged to enter the Euro through the ERM II mechanism. This requires adhering to the SGP criteria both before and after adoption of the Euro. If a Eurozone member failed to uphold the fiscal criteria for three consecutive years, they were to be subjected to the

Excessive Deficit Procedure (EDP) which consists of a series of Council recommendations followed by increasingly severe sanctions with eventual fines.

However, even before the late-2000s global financial crisis, the SGP criteria were routinely ignored in actual practice and the EDP was never effectively implemented. By the time data emerged for the 2009 fiscal year, it became clear that the majority of Eurozone member states were in violation of the SGP criteria while non-Euro member states, aside for Slovakia, appeared to be diverging from the criteria as well. Beginning with debt and currency crises in Hungary, Latvia and Romania, followed by

default threats from Eurozone members Greece, Spain, Portugal and Ireland, the SGP has been effectively ignored while the ERM II has been sidelined on a case-by-case basis. This comes in spite of a continuing

effort by powerful member states, Germany in particular, to enforce the SGP criteria through EU-level approaches. Unfortunately, leverage to enforce the criteria is gained only in the most desperate member states who have applied for emergency loans. However, even within those member states, the EU has not uniformly pressured governments, as the cases of Hungary, Latvia and Greece illustrate. Therefore, a brief exploration of the differences between these cases will demonstrate the need to adopt a more uniform approach.

### Crisis in Hungary, Latvia and Greece

Although every country in Europe faced struggles deriving from the financial crisis, some were hit harder than others. The financial crisis brought considerable turmoil in Hungary, Latvia and Greece – each for different reasons. However, each required an emergency loan to prevent defaulting on its commitments,

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and each of these loans came with conditions. Because the EU has become an important actor in determining these conditions, it is important to understand how a lack of uniform response, largely due to each country's differing relationship with the Euro, delegitimizes the EU in member-states engulfed in crisis.

Hungary reached over 9% fiscal deficit levels in 2006. During the liquidity crisis in late-2008, the Hungarian government was forced to secure a joint EU and IMF loan because it couldn't obtain sufficient funds from its paralyzed bond market. This loan was necessary despite the prior institution of an austerity program which brought its deficit to 3.8% by 2008. Insiders have documented the particularly vociferous role of the EU in promoting even further austerity and opposing the rapid and unilateral entry of Hungary into the Eurozone – a potential measure to resolve the crisis. The EU opposition to this possible solution, coupled with the deep unpopularity of EU-pressured austerity measures, contributed to the April 2010 election of Viktor Orbán's Fidesz Party, in a populist-nationalist coalition. Riding a wave of anti-EU and anti-banking public sentiment, Orbán promptly refused the remaining funds of the emergency loan package, refused further austerity measures demanded by the EU and IMF, and instead imposed a controversial bank tax to generate the additional revenue for the government. It is too early to determine the result of these measures, but it is certain that Hungary has directly challenged a coordinated European response to crisis and implicitly suggested an unwillingness to enter either the ERM II or the SGP – both uncomfortable precedents for the EU.

In contrast, Latvia had entered the ERM II in 2005 when it was known as the 'Baltic Tiger.' By late 2008, Latvia applied for emergency loans from the IMF and EU due to liquidity problems. The EU again pressured Latvia to adopt painful austerity measures and refused unilateral Euroization. However, partly due to the government's obstinate refusal to devalue the lat from the peg set by the ERM II in 2005, despite extending the target entry to the Euro from 2012 to 2014, the government succumbed to EU pressure for austerity. As a result of this austerity in the face of crisis, Latvia suffered both the highest unemployment and highest GDP decline in Europe.

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Greece, already a member of the Eurozone, began to show signs of an even larger debt crisis after national elections in October of 2009. The new government of George Papandreou disclosed that the previous government had manipulated fiscal figures and the Greek deficit was actually over 12% of GDP. This resulted in a credit downgrade for Greek sovereign bonds, sending shockwaves through the bond market and lead to a sharp rise in the rate for Greek bonds as well as fears of similar problems with Spain, Portugal and Ireland. This prompted an emergency meeting by the EU, and largely through the

leadership and financial backing of Germany, the creation of the European Financial Stabilization Facility (EFSF), an emergency fund designed to restore confidence in sovereign debt through conditional loans to any member state in need – the first of which was Greece. After receiving these emergency loans, although praised by

lender countries for its institution of painful austerity measures in the face of often violent public protest, many lenders believe that the Greek government has not done enough.

In each case, the European Union adopted the policies most favored by lender states or financial actors and deeply unpopular with the populations of those countries engulfed by crisis. However, it appears that only a commitment to the ERM II was sufficient to actually follow the EU advice. The strength of the EU's position therefore results from a given member state's relation to the Euro. If all member states are to be considered equals, then the establishment of a permanent crisis mechanism must be uniformly applied in the future.

### Setting up a Permanent Crisis Fund in Response

By late October 2010, stemming from a series of initiatives spearheaded by German Chancellor Angela Merkel, the EU agreed in principle to establish a permanent crisis fund to protect the Euro, much like the EFSF's temporary fund. This fund would be bankrolled by every member state, including those outside the Eurozone, and wielded as an instrument to ensure financial stability, as well as fiscal austerity, in Eurozone members engulfed in crisis. At the same time, an aspect of the plan called for private actors, who were often responsible for

bond market instability through speculation, to contribute to the fund.

Two key points of this permanent mechanism, and which have not yet been determined, are how private actors will help finance the fund and what its relationship will be with those member states that have not adopted the Euro. Few consider the measure negotiable outside the dominant preferences of Germany, and therefore the policy visions of the current German government are of key importance. First, it appears the current German position is for all member-states to contribute to the fund, but only Eurozone members will be covered by it. Secondly, in November of 2010, German Finance Minister Wolfgang Schäuble disclosed in an interview with *Der Spiegel* regarding how private actors will finance the fund: "I imagine a two-stage process. If a country is having financial difficulties, the EU will launch an austerity and restructuring program, as it did in the case of Greece. In a first step, the maturities of those bonds that come due in this critical phase could be extended. If that doesn't help, private investors will have to accept a markdown on their claims, in a second step. In return, they'll receive guarantees on the rest."

## Recommendations

1. There is a relatively simple solution to how private actors will finance a fund which is explicitly designed to contain, through public intervention, their speculative excesses. The suggestions of Wolfgang Schäuble are both insufficient and excessively complex in practice. Therefore, the fund should be financed through a miniscule, but European-wide, exchange fee on bond transactions. Instead of creating an instrument controlled by the dominant member states to force conditional austerity on the poorer nations, it will create a powerful multi-lateral institution that will serve the purposes of every EU member state while protecting the Euro.

2. This exchange fee should be levied at every point of bond purchase or exchange of bond-based securities. Therefore, if the fee has any effect at all on the bond market, which is unlikely if applied universally, it will only discourage excessive short-term speculation because rapid turnover will become increasingly less profitable due to accumulated fees on exchanges. Considering the volume of bond-market

transactions, a fee of considerably less than 0.1% should easily provide sufficient resources for the EU crisis fund without deterring legitimate long-term investors from buying government bonds.

3. The fee should be instituted at the national-level for all member states, but directly supplying the EU-level supranational fund. Therefore, because of the fee's universal application, it will not violate any EU rules on competitiveness and economic integration between member states. Moreover, a fee levied on financial actors in the bond market will be both cheaper and more palatable for the donor states' citizenry than directly bankrolling the fund by taxpayers. The current environment of public sentiment is sharply critical of private actors still profiting from publicly bailed out financial markets, especially considering the European-wide calls for austerity measures – measures which are never popular.

4. Short-term debt financing is a significant reason for financial volatility and crisis. The EU should work towards more structured long-term government finances. However, this is better accomplished not through vague regulations applied unsystematically at the national level, but a single institutional mechanism which discourages short-term financing.

5. Allow all member states to have access to the permanent crisis fund. This will do away with the separate institutional mechanism of the Balance of Payments Facility which continuously demonstrates, like with the differing policies adopted for Hungary and Latvia, a divergent policy for countries with similar problems. This divergence is both politically damaging to the European project and a disincentive to join the ERM II. Without a uniform set of procedures for all member states engulfed in crisis, capricious negotiations and routine violations of existing agreements with the EU becomes the norm. Moreover, the very likelihood of a Eurozone emergency fund obtaining consensual approval, when bankrolled by all members of the European Union, is quite dismal. With Sweden and the United Kingdom having de facto opt-outs from the Euro, it is unlikely that these primarily EU donor countries would support such a proposal as its details become clearer.

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